

22 June 2009

Immigration Lifts GDP Bar

- Q1 GDP expected to fall 0.7%
- Falling migrant departures boosting population
- But lifting GDP breakeven bar with it
- Tourism holds up in May
- Consumer confidence likely better through Q2
- External deficit on course for 6% of GDP this year

We expect the good news in Friday's national accounts to be that the economic contraction was beginning to moderate in the early stages of this year. We anticipate Q1 GDP fell 0.7%, following the 0.9% decline reported for Q4. This is in line with the market's median expectation.

However, the market range is fairly wide, which we can understand. The available hard-wired inputs to GDP have been variegated enough to suggest March quarter activity might not decline quite as much as the 0.7% we expect. However, the more generalised indicators warn of a drop more toward the 1.0% mark, which is where some of the local pollsters are pitching things. The RBNZ was similarly inclined, with the 1.0% decline it had built into its June MPS.

As for the stories, there will be no lack of sufferers, with manufacturing probably the worst, but with wholesaling and retailing also with big holes. Moderate falls are likely for agricultural production, transportation, construction and electricity generation. Positives will tend to linger in the services and government-oriented sectors, with finance and insurance services probably solid again, but with oil, gas and coal production the biggest gainer to keep an eye out for.

From the spending side, consumption will likely be a sore spot, yet again, but with business expenditure on plant machinery and transport goods now the clearest area of capitulation. Goods exports likely rose a bit in volume

terms, but principally because of a huge run-down in previously bloated dairy product (manufactured) inventory. Services exports will likely slip further, as the beginnings of the tourism decline become more evident.

Imports will undoubtedly collapse in Q1 – reflecting very weak domestic demand and the need to keep inventories from ballooning. The positive features, if you can call them that, are likely to be in government-related expenditure.

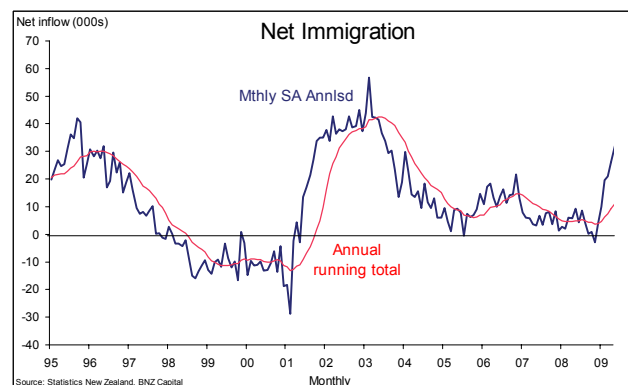
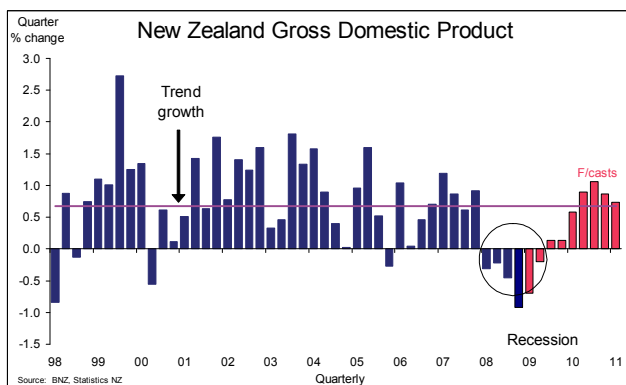
Unless there is a big surprise in the Q1 GDP data, however, we'll likely be left with an impression the economy is beginning to find some sort of toehold in the degree of recession it's experiencing.

In keeping with this, we believe Q2 GDP "growth" is shaping up to be much less negative than Q1's. We presently have -0.2% on the board. It might yet claw back to flat, with even a faint chance it prints slightly positively (albeit on one-offs). Then again, Q2 GDP might well catch overhanging weakness in some sectors – residential construction being a clear example – that might keep the overall decline obvious. We'll see.

While we remain cautious about the underlying vulnerabilities of any genuine recovery taking shape, there is at least some chance headline GDP will post mild expansion over the second half of 2009.

Still, the economy seems well shy of getting back to "normal" growth, let alone achieving the above-trend rate of expansion that will be required to soak up the spare capacity that will inevitably keep emerging for the next six months, at least.

Related to GDP, the role of immigration is becoming more and more important to bear in mind. As this morning data made clear, the population is increasing at a more positive



rate, as New Zealand experienced a net immigration gain of 2,690 in May, seasonally adjusted – the highest since 2003.

Importantly, this is not because foreigners are flooding to these shores to live. Indeed, the number of non-New Zealand nationals that arrived during May was 6% (272) lower than a year earlier. And there is little reason to expect any pipeline turnaround, if what we're hearing about applications for residency is correct.

Instead the "immigration" gains are wholeheartedly coming by way of local Kiwis, who would normally have ventured abroad, deciding to stay put – no doubt related to the deep dark global recession and its impact on labour markets worldwide. Such departures fell an annual 29% in May, or 2,020 in number. Yes, there has also been a 10% annual increase in Kiwi ex-pats returning home. But this was a relatively minor 150 extra.

This composition is important for understanding the implications for the economy. It does not mean, for example, hordes of foreigners are turning up with hard currency wanting to buy, buy, buy, especially housing. In fact, the reverse is true. However, the nesting of Kiwis is supportive of spending (and might even be part of the reason new listings of homes for sale have dried up as much they have).

Of course, there will come a time when this back-logging of Kiwis will venture abroad once again, thus reversing the positive immigration impacts, as usual. But this doesn't look likely until the world economy, and its labour market, looks a safer place, which might not be for some time.

For the meantime, then, we can imagine stay-at-home Kiwis will provide some timely buffer for the expenditure side of the economy (albeit as they worsen the game of musical chairs for the dwindling number of jobs available). This will be instrumental in lifting population growth to stronger rates than we've seen over recent years.

This, in turn, is important for thinking about GDP. On one level, it suggests we should be building in a better potential GDP growth, simply because of the

stronger population expansion. However, this carries the implication that GDP would need to "naturally" expand by, say, a greater 0.5% per quarter, rather than 0.25%, simply to keep pace with the workforce.

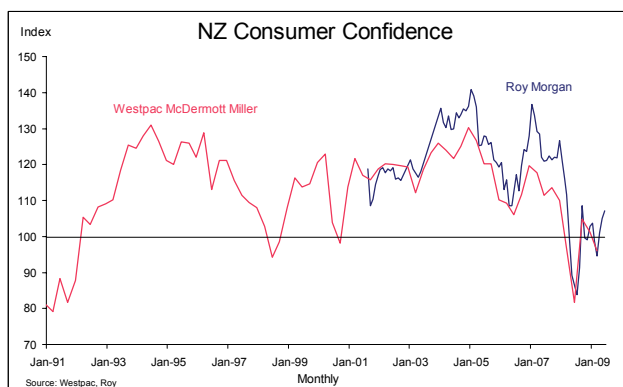
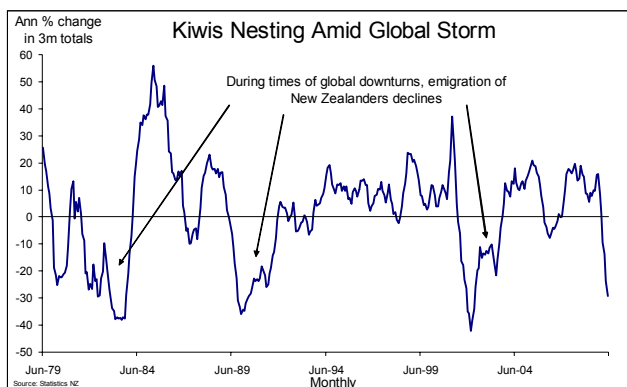
So any mild gains in GDP we might eventually see would ultimately be extremely disappointing, implying either declining productivity or an increasing degree of slack in the economy. By the same token, increasing population growth simply raises the bar on what GDP growth needs to be in order to denote a genuine recovery, in the sense of soaking up the slack.

When it comes to short-term visitor flows, however, the news is less equivocal, in that a declining trend is surely in place. Not that May's arrival numbers were awful. In fact, they increased a fraction, in seasonally adjusted terms, to be 1% higher than a year ago. However, it would be a bold person to bet on numbers holding up over the next six to twelve months, especially with the influenza A H1N1 only beginning to wreak its full effects.

Meanwhile, short-term trips abroad by New Zealand residents are already in clear retreat. They fell 1.5% in May, to be 5.9% down on a year ago. This should, as with the migration trends, support domestic spending. However, there seems little evidence that this actually occurring to any obvious degree.

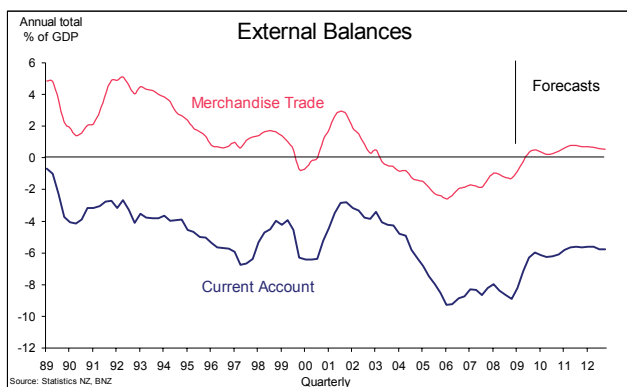
At least consumer confidence is improving. We expect Westpac's measure of such, published Wednesday afternoon, will confirm a further step away from the dark side, to about 105, from March's not-so-flash 96.0. Still, it would be nothing to base any sort of recovery on, in being barely back to average, despite recent tax cuts, substantial interest rate relief, a jobless rate not too far from long-term norms, falling inflation, even signs that the global recession is abating.

If all of this hasn't set consumer confidence alight then we don't know what will over the foreseeable future. Indeed, it leaves us wondering how consumer confidence will fare as the unemployment rate keeps rising, salary and wage increases become much less common, income from the rural sector is curtailed and yields from investments remain relatively low.



And speaking of vulnerabilities, Thursday sees the release of New Zealand’s March quarter Balance of Payments statistics. We’re expected a less-ugly deficit – of around 8.2% of GDP for the full year to March 2009. This is a bit less than the 8.4% picked by the market.

The detail should give hope that a turnaround is in train, not just better at this station. While higher exports will mainly be a timing issue (drawn from stocks) collapsing imports will be genuine relief, as domestic demand continues to correct from its prior excesses. Lower interest payments (as interest rates abate), on a more slowly increasing amount of foreign debt, will help moderate investment income debits in the current



account, as will weaker local profits accruing to non-resident foreign direct investors.

In general, we believe New Zealand’s external deficit will keep contracting over the coming year, although might struggle to get much below 6% of GDP over this time – especially if the trade-weighted exchange rate, which is already back up to average levels, proves stronger than is reasonably justified.

Of course, Thursday’s current account figures also have the potential to fine-tune our GDP calculations at the death. But barring any big surprises in its export and import content we’ll be looking for a 0.7% decline in Q1 GDP for Friday.

We certainly believe the rate of economic contraction is now abating, partly with the help of stronger population growth, as fewer Kiwis migrate for the meantime. By the same token, if we don’t start to see some properly positive growth indicators over the coming months, then we’ll be getting worried about underlying conditions. We could say the same about the global economy, following the much greater amounts of costly stimulus it has had thrown at it.

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Domestic Interest Rates

NZD interest rates generally saw a small sell off over the course of the week with little domestic data to drive the market. While the 3m bill rate rallied somewhat on the week, the futures curve generally sold off. The front futures contract is now pricing effectively a zero chance of further cuts to the OCR, while the OIS is still pricing roughly a 30% chance of a 25bp cut at the next meeting. Paying the short dated OIS while hedging in the September futures contract would thus seem to be a good trade, although you do run the risk of a bank bill margin increase if credit conditions worsen.

The Government bond market saw a sell off and gentle flattening on the week, with the New Zealand market strongly outperforming badly hit markets both in Australia and the US. With a very heavy worldwide market it seems likely that NZ bonds will struggle this week, particularly if we don't see a rally before the tender on Thursday.

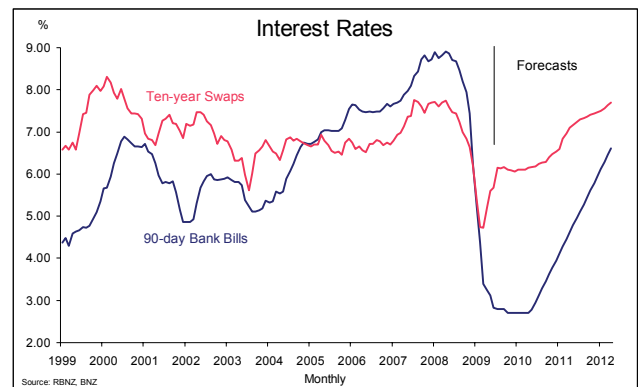
The swaps market also sold off on the week, again pushed primarily by offshore moves. There was a small

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
12-Jun-09	2.86%	3.80%	6.01%	3.86%	6.09%	223
19-Jun-09	2.81%	3.90%	6.06%	3.92%	6.20%	223
Change (bps)	-5	10	5	6	11	0

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steepening to the curve, but 2yr-10yr is still around 20bp flatter than at the high point of the cycle. Flows and offshore indicators will likely drive the market in the coming week. Technically, two year swap rates peaked at 3.98% after the last OCR announcement, we would expect strong receiving interest at around this level. If we pushed through there, the next major level is around 4.20%, the peak during the March wave of mortgage book paying.

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Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Bearish
 MT Resistance: 5.75%
 MT Support: 5.15%

The 5-year swap rate has broken resistance at 5.15% and looks set to head higher. Short term resistance is at 5.46% and we expect this to break and head towards the 5.75% level. Only a move below the 5.15% level would negate this outlook.



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NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Steepening
 ST Support: +122

Steepening continues unabated and we will wait for a pullback to see where resistance is. Support is still at the previous resistance, of +122.



Foreign Exchange Market

After slipping briefly below 0.6250 mid week, NZD/USD finished the week on a firmer footing closer to 0.6450.

Early in the week, NZD/USD was pressured by a generally firmer USD (after Russian and Japanese officials reaffirmed the USD's status as the predominant reserve currency) and steady selling of NZD/JPY from Japanese based accounts. However, the NZD recovered towards the end of the week as risk appetite rebounded and improving US data helped convince investors the US recession may be bottoming. Our risk appetite index finished the week around 36%, well up from Monday's 32%.

There was also a big sell-off in NZ swap rates late last week (2-year swap rates rose 20bps to 3.95%) and paying from domestic mortgage books is expected to keep NZ swap rates underpinned again this week. NZ-US 3-year swap spreads widened by about 10bps last week to 2.35% and any further widening pressure should help keep NZD/USD underpinned.

There is plenty of event risk to keep an eye on this week. Although the Fed is widely expected to leave both rates and its quantitative easing program unchanged, the FOMC statement will be the key event. If the Fed reiterates that interest rates in the US will remain low for some time to come (and conveys a sense that rate hikes are unlikely before year-end) the USD will likely come under fresh selling pressure (expect the USD Index to re-test support in the 79.00 region). However, if the FOMC hints that its ultra easy monetary policy can't last forever and that it's

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time to starting thinking about an exit strategy, the USD may extend its recent recovery (expect the USD Index to re-test resistance in the 81.50 region).

It will also be important to keep watching US bond yields and the shape of the yield curve. Over the past few weeks, the USD has tended to strengthen as the US yield curve has flattened (reflecting a reassessment of inflation expectations and reduced concern about souring offshore demand for longer dated US denominated debt). This week sees record issuance of US\$104b worth of US Treasury notes and investors will be nervously watching for how this supply is absorbed. Should longer dated US yields sell-off strongly, and the yield curve steepen, this will likely add downward pressure to the USD.

Locally, the data calendar is also full. Westpac's quarterly consumer confidence reading is expected to nudge up to around the 105-110 region, while Thursday's balance of payments (Q1) will likely register an improvement, the result of falling offshore debt servicing flows (courtesy of lower global interest rates), decent export volumes and weaker imports (of both the consumption and investment varieties). And we forecast a 0.7%q/q decline for Friday's Q1 GDP.

All up, it will probably be a choppy week for NZD/USD. However, we expect dips will be limited to the 0.6300-0.6350 region and suspect we'll see a push back towards 0.6550-0.6600.

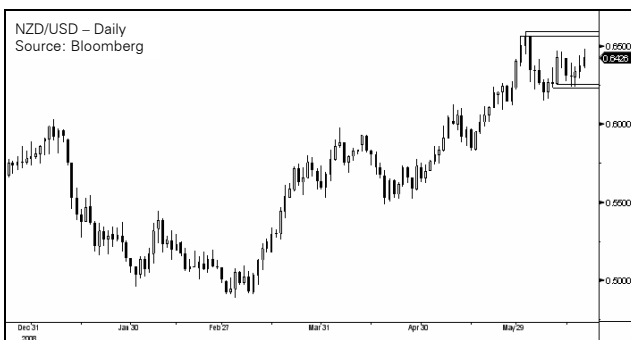
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Foreign Exchange Technicals

NZD/USD

Outlook: Buy a dip
 ST Resistance: 0.6480 (ahead of 0.6550)
 ST Support: 0.6250 (ahead of 0.6155)

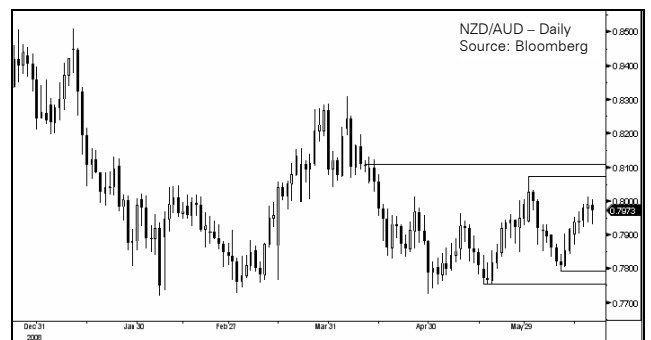
While the currency trades above its 20-day low of 0.6155, we'd view dips as buying opportunities. A break above 0.6480 will open up the topside back towards the June high of nearly 0.6600.



NZD/AUD

Outlook: Buy a dip
 ST Resistance: 0.8070 (ahead of 0.8110)
 ST Support: 0.7780 (ahead of 0.7755)

Momentum indicators are neutral and the repeated failure to sustain dips below 0.7750 suggests a period of consolidation is in order.



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Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 22 June				Wednesday 24 June <i>continued...</i>			
NZ, Credit Card Billings, May			+2.3%	US, Durables Orders, May		-0.8%	+1.9%
NZ, External Migration, May s.a.			+2160	US, FOMC Policy Announcement	0.25%	0.25%	0.25%
Jpn, Tertiary Industry Index, April	+2.3%		-4.0%	Thursday 25 June			
Jpn, MOF Business Survey, Q2			-51.3	NZ, Balance of Payments, Q1	-8.2%	-8.4%	-8.9%
UK, Rightmove House Prices, June			+2.4%	UK, King Testifies to Treasury			
Germ, IFO Index, June		85.0	84.2	Committee, Banking Crisis			
Tuesday 23 June				Euro, Industrial Orders, April			
All, OECD Economic Outlook						flat	-0.8%
UK, BBA Home Loans, May			27,685	US, Jobless Claims, week ended 20/06		600k	608k
Euro, PMI Manufacturing, June 1st est		42.1	40.7	US, Bernanke Testifies, BofA/Merrills Deal			
Euro, PMI Services, June 1st est		45.6	44.8	US, GDP, Q1 saar 3rd est		-5.7%	-5.7%P
US, Existing Home Sales, May		4.82m	4.68m	Friday 26 June			
Wednesday 24 June				NZ, GDP, Q1			
NZ, Wpac Consumer Confidence, Q2	105.0		96.0	Jpn, All Industry Index, April		+2.3%	-2.4%
Jpn, Merchandise Trade Balance, May	+Y203.5b		-Y52.2b	Jpn, CPI, May y/y		-1.0%	-0.1%
UK, CBI Dist Trade Surv, June				US, Mich Cons Confidence, June 2nd est		69.0	69.0P
US, New Home Sales, May		360k	352k	US, Personal Spending, May		+0.3%	-0.1%
				China, Industrial Profits, May ytd y/y			-37.3%

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	2.50	2.50	2.50	8.25	NZD/USD	0.6426	0.6395	0.6151	0.7604
1 mth	2.80	2.85	2.75	8.59	NZD/AUD	0.7983	0.7900	0.7858	0.7974
2 mth	2.84	2.84	2.78	8.65	NZD/JPY	61.82	62.93	58.27	81.55
3 mth	2.81	2.81	2.77	8.72	NZD/EUR	0.4605	0.4572	0.4384	0.4866
6 mth	2.82	2.83	2.80	8.65	NZD/GBP	0.3893	0.3893	0.3861	0.3851
GOVERNMENT STOCK					NZD/CAD	0.7294	0.7154	0.6893	0.7728
07/09	2.65	2.65	2.68	7.08	TWI	60.78	60.60	58.46	68.02
11/11	3.90	3.79	3.66	6.50	NZD Outlook				
04/13	4.90	4.84	4.57	6.41					
04/15	5.54	5.48	5.19	6.44					
12/17	6.06	6.00	5.72	6.44					
CORPORATE BONDS									
BNZ 09/10	4.30	4.29	7.50	-					
BNZ 05/15	7.40	7.43	8.68	-					
GEN 03/14	7.19	7.48	7.25	-					
GEN 03/16	7.98	8.04	7.65	-					
TRP 12/10	4.65	4.63	7.00	8.01					
TRP 06/20	7.93	7.84	6.95	7.87					
SWAP RATES									
2 years	3.92	3.85	3.55	7.89					
3 years	4.67	4.56	4.18	7.71					
5 years	5.42	5.30	4.92	7.56					
10 years	6.20	6.08	5.76	7.42					

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